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A tale of two Mexicos: Growth and prosperity in a two-speed economy

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A tale of two Mexicos: Growth and prosperity in a two-speed economy

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A two-speed economy …

Productivity has grown **5.8%** a year in large modern firms

but has fallen **6.5%** a year in traditional firms

Small traditional firms were **28%** as productive

as large modern ones in 1999, **8%** in 2009

Employees in traditional bakeries are **1/50th**
as productive as those in largest modern companies

53% of small and mid-sized Mexican firms
are underserved by the banking industry

Without an acceleration in productivity gains,

GDP growth could drop to **2%** a year

… slows down growth

0.8% average rate of productivity growth from 1990 to 2012

Wages in traditional firms fell **2.4%** a year from 1999 to 2009

Manufacturing in Mexico is **24%** as productive as in the United States, even though top plants exceed the US average

Mexican businesses face an estimated **$60 billion** credit gap

To reach the **3.5%** GDP growth target, productivity growth would need to triple

Executive summary

Twenty years after the signing of the North American Free Trade Agreement (NAFTA), the question remains: What is Mexico? Is it a dynamic industrial power that builds more cars than Canada and has become a global auto exporter? Or is it a land of traditional slow-growing businesses and informality? Has it found the right combination of reforms to restore rapid GDP growth and rising living standards? Or is it stuck in a perpetual cycle of economic advances and retreats? Is it a modern, urbanized state that has adopted market reforms and built well-functioning institutions, or is it a place where corruption and crime are tolerated?

According to the media, Mexico is all these things and more. These dichotomies, however, are more than provocative story lines. They reflect the dualistic nature of the Mexican economy. There is a modern Mexico, a high-speed, sophisticated economy with cutting-edge auto and aerospace factories, multinationals that compete in global markets, and universities that graduate more engineers than Germany. And there is traditional Mexico, a land of sub-scale, low-speed, technologically backward, unproductive enterprises, many of which operate outside the formal economy.

It is precisely the deep division between the two economies that has kept Mexico's growth at disappointingly low levels despite three decades of economic reforms. This report, the product of a six-month study by McKinsey's Mexico office and the McKinsey Global Institute, focuses on the two-speed nature of the Mexican economy. We find that the duality of modern and traditional Mexico permeates the economic life of the nation, influencing performance across all sectors and regions, and determining the path of the overall economy.

What makes this dichotomy important now is that the two Mexicos are pulling in opposite directions. As the modern economy celebrates the NAFTA anniversary and triumphs such as the opening of yet another world-class auto plant, the traditional sector is moving backward. The productivity of small establishments (with ten or fewer employees) declined from 28 percent of the level of large companies (those with more than 500 employees) in 1999 to 8 percent in 2009. Yet these traditional unproductive firms are creating jobs at a faster rate than modern firms—the opposite of what typically happens as economies develop.

The declining performance of the traditional sector and its rising share of employment explain why three decades of reforms have failed to raise Mexico's overall GDP growth. Measures to privatize industries, embrace free trade, and welcome foreign investment have helped create a highly productive and globally competitive modern Mexico where multinationals such as FEMSA, Grupo Alfa, Grupo Bimbo, Grupo Lala, Mabe, Walmex, and many others have flourished.[1] Today they have access to global capital and employ the latest technology. They

1 List of top public companies in "500 Empresas de Expansión," *Expansión*, June 2013, in manufacturing and retailing with a principal listing in Mexico and/or private companies (non-subsidiary), headquartered in Mexico.

have become leaders in some of the most competitive markets in the world. But reforms have barely touched the other Mexico, where traditional enterprises operate in the same old ways, informality is rising, and productivity is plunging.

The question overhanging Mexico today is whether the current reform agenda of the Enrique Peña Nieto administration can drive economic growth across both modern and traditional Mexico. For Mexico to get closer to the pre-1980 growth rates that can raise per capita income, grow the middle class, and bring more people out of poverty, the nation must reverse the stagnation of the traditional segment and narrow the gap between the two Mexicos. Policies and practices that discourage traditional businesses from formalizing so that they can qualify for financing and invest in growth need to be rethought. More companies and workers need to move into the modern economy, creating a vibrant and globally competitive small and medium-sized enterprise (SME) sector. To reach Mexico's ambitious growth goals, the modern segment also needs to continue to improve productivity, expand, and create jobs. Policy makers should address remaining barriers to growth for all companies, including inadequate education and infrastructure, limited access to capital, and high energy costs.

Among the key findings of this report:

- Mexico's slow income growth in the past three decades—GDP per capita rose by just 0.6 percent per year on average and only 0.4 percent during 2013—is due to weak labor productivity, which fell from $18.30 per worker per hour (in purchasing power parity) in 1981 to $17.90 in 2012.

- Behind the productivity averages are two dramatically divergent trends: the productivity of large modern enterprises, many of which have become integrated into the global economy, has risen by 5.8 percent a year since 1999; in small traditional enterprises, productivity is falling by 6.5 percent a year. In between are mid-sized companies—a mix of traditional and modern establishments whose productivity growth has been close to flat at about 1.0 percent a year. Overall, the gains of modern companies have been all but offset by the decline in traditional ones, leaving economy-wide productivity growth at about 0.8 percent a year since 1990.[2]

- Faster job growth in the traditional sector is shifting more labor to low-productivity work. The traditional segment has accounted for 48 percent of job growth since 1999. Large modern enterprises are expanding, too, but are not creating jobs fast enough to raise their 20 percent share of employment. The share of employment of mid-sized companies dropped from 41 percent in 1999 to 38 percent in 2009, making Mexico's employment increasingly polarized between two extremes. This hollowing middle is seen across most sectors. In manufacturing, declining trade barriers have created new opportunities for expanding multinationals, but many mid-sized domestic producers have been squeezed between increasing competition from low-cost imports and small local fabricators that derive cost advantages by operating outside the formal economy, thereby avoiding taxes and other costs.

2 See Box 1 for a definition of traditional and modern segments. We use company sizes as a proxy for our estimates, defining companies with ten or fewer employees as mainly traditional; companies with 11 to 500 employees as mid-sized; and those with more than 500 employees as large modern enterprises. This estimate likely understates the gap between modern and traditional, since it counts small modern establishments such as outlets of convenience store chains and small professional services firms that have strong productivity as traditional.

- A central focus of productivity-improvement efforts needs to be reversing two unwelcome trends: the declining productivity of traditional enterprises and their rising share of employment. This will involve raising productivity in traditional enterprises and creating opportunities for successful ones to grow into modern, formal SMEs. To achieve this, Mexico must create a business environment that encourages entrepreneurship and growth and removes economic incentives for businesses to remain small and informal. A critical part of a successful strategy will be to improve enforcement. Simplifying regulatory processes can also help companies join the formal economy: it costs twice as much (as a percentage of average income) to register a business in Mexico as in Chile—and seven times as much as in the United States.

- While addressing the problems of the traditional sector, Mexico also needs to continue to raise productivity of modern firms, particularly mid-sized companies, and expand employment in the modern sector. A key priority for making mid-sized companies growth engines for Mexico is to improve access to capital. Mexico lags far behind its emerging-market peers in bank lending, a key source of funding for mid-sized businesses. The World Bank estimates that more than half of Mexico's small and medium-sized businesses have insufficient access to financial services, and lack of access for businesses with ten to 250 employees accounts for most of what we estimate to be a $60 billion credit gap for Mexican business.

- Expansion and hiring by modern-sector firms should be encouraged. Despite recent reforms, requirements in Mexican labor regulations continue to discourage hiring of full-time employees. Companies still have limited flexibility to lay off workers or hire part-time employees. They also must contribute to profit-sharing plans. To skirt these requirements, more and more employers are hiring even core personnel through contractors. Zoning regulations also hinder growth by keeping modern-sector firms out of many neighborhoods.

- Broad measures are needed to support growth across the Mexican economy. They include reducing electricity costs, upgrading infrastructure, improving labor-force skills, and continuing to improve security. These "enablers" will be important for continuing productivity improvements of modern and traditional companies alike—steps that are critical to reaching overall productivity goals.

- Productivity-raising measures need to be adopted soon. Mexico's productivity imperative is made more urgent by the fading of the "demographic dividend," the rapid expansion of the labor force due to population growth that has contributed 2 percentage points of GDP growth (or 72 percent of overall growth) since 1990. To reach GDP growth of 3.5 percent a year as labor-force growth slows, the productivity growth rate would have to rise almost three-fold from the 0.8 percent per year average since 1990.

We believe that with the right measures, Mexico can accelerate productivity improvements and raise GDP growth to 3.5 percent a year or even higher. Mexico's new administration has launched an ambitious set of reforms that have the potential to address several, although not all, of the constraints we identify. The approval of controversial reforms—in areas ranging from education to energy—has impressed many observers. In our work we have not evaluated the

current reforms that have been adopted or are still under consideration. However, the impact of any reform agenda depends on translating broad agreements into detailed policies and legislation and implementing them across the nation.

How well this is done will determine whether Mexico can live up to expectations and rebuild a high-growth economy that can create better jobs, an expanding middle class, and rising living standards. We recognize that identifying reforms and new policies to unleash productivity growth is the easy part. Carrying them out requires changes in long-standing practices, which will require new capabilities and new ways of doing business. Ultimately, Mexico's ability to reignite growth depends on building a modern economy: a place where formal, compliant companies grow and prosper—and inspire others to emulate their success.

From a Mexican Miracle to stagnation

To understand the potential of the Mexican economy, it is useful to remember what was accomplished before the 1980s. From the early 1950s through the 1960s and 1970s, Mexico urbanized and industrialized at a rapid clip. GDP rose by an average of 6.5 percent annually. From 1950 to 1970 productivity rose by 4.3 percent a year on average. This "Mexican Miracle" was hailed as a model for economic development around the world.

The miracle era passed, however, and growth never recovered. The great expansion of public spending under the "shared development" program in the 1970s led to financial imbalances that proved unsustainable when oil prices plunged. This resulted in a financial crisis and devaluation in 1982. Since 1981, GDP growth has averaged 2.3 percent a year—mostly due to the expanding labor force—and GDP per capita has grown by a disappointing 0.6 percent a year. Labor productivity, which fell sharply from its 1981 peak, has yet to recover completely in purchasing power terms. In 2012, the output of the average Mexican worker was about $17.90 per hour in purchasing power parity, still below the $18.30 per hour of 1981. Mexican GDP per capita, which was 12 times China's in 1980, is now only 25 percent higher, and, at current growth rates, China could surpass Mexico by 2018.

Many factors have affected growth and productivity in Mexico over the past three decades, including volatile energy prices and serious financial crises. However, we find that in good times and bad, it is the stagnation of the large pool of traditional enterprises that limits GDP and productivity growth. Traditional enterprises employ 42 percent of all workers, yet contributed just 10 percent of the total value added in the Mexican economy in 2009. (For definitions of traditional enterprises, informality, and other terms we use in our analysis, see Box 1, "Defining our terms: Modern, traditional, formal, and informal.")

Box 1. Defining our terms: Modern, traditional, formal, and informal

It is clear that there are two versions of the Mexican economy. There is a traditional Mexico that employs millions of workers in labor-intensive, low-productivity tasks, and there is a modern Mexico that consists of both large multinationals (Mexican and foreign) and successful domestic corporations. Thousands of mid-sized companies fall somewhere between these extremes. There is also a formal economy and an informal economy. However, it is not easy to draw clear lines between categories. A company can have fewer than ten employees yet be fully modern and formal and rely on state-of-the-art ways of doing business. At the same time, even some large companies, those with more than 500 employees, hire informally. Here is how we define the following categories in this report:

- **Modern.** A modern enterprise uses the standard business practices found across organizations in advanced economies, with formal controls, resource allocation, and management systems. A modern firm typically hires qualified managers and uses machinery and information technology to raise productivity. Modern companies, even if they are owned by a sole proprietor, tend to be growth-oriented and have strategies and goals.

- **Traditional.** A traditional business does not use modern business methods or tools. It may be informal—with employees working "off the books"—or it may be part of the formal economy. A traditional player is unlikely to be able to invest in productivity-improving equipment and technology and may use manual methods or antiquated machinery. Traditional businesses may exist to provide a living for the owner and his or her family.

- **Formal.** Formal companies are registered businesses that pay all corporate taxes and submit to relevant regulation. Their employees work on the books, and the company withholds required tax and social security payments. The workers have rights to severance payments, must be paid a minimum wage, and can form unions.

- **Informal.** Informal businesses fail to comply with all regulatory requirements. They may not be registered with the authorities; they may under-report income to avoid paying all or part of their tax obligations; and they may pay bribes to avoid land-use, sanitary, or other regulations. There are many shades of informality, ranging from large modern companies that cut corners in parts of their operations by hiring informally, to mid-sized companies that are properly registered yet employ most of their workers informally and may not comply with a full range of health or other regulations, to completely informal businesses that operate entirely under the legal radar.

Mexico faces a growing productivity imperative

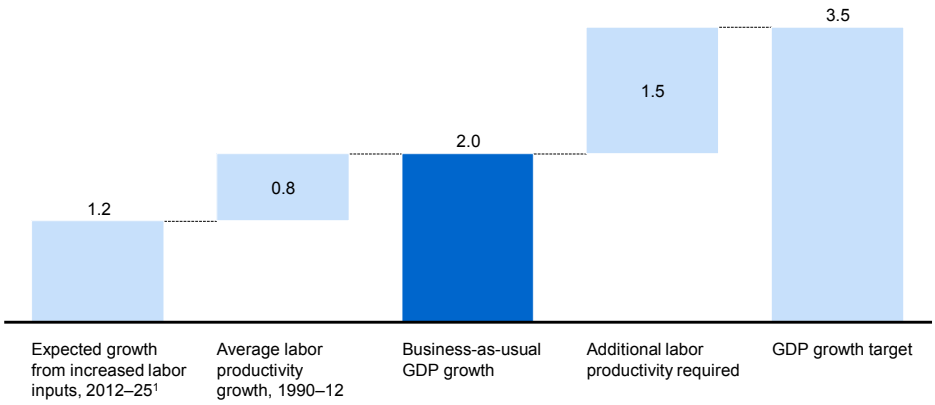
The low productivity of traditional companies is at the heart of Mexico's growth challenge. GDP growth has averaged 2.7 percent annually since 1990, largely due to a rapidly expanding labor force. Labor inputs have accounted for more than two-thirds of GDP growth. Now, this "demographic dividend" is beginning to decline; labor-force growth is expected to fall from 2 percent annually to 1.2 percent through 2025. Productivity will need to take up the slack to sustain GDP growth. If productivity does not accelerate from the recent rate of 0.8 percent per year, Mexican GDP growth could decline to 2 percent a year. To raise the GDP growth rate to 3.5 percent, the growth projection by the Central Bank of Mexico for 2014, productivity would need to rise by 2.3 percent annually—almost three times the rate of the 1990 to 2012 period. To meet the government's 6 percent goal would require raising productivity by 4.8 percent annually, or about six times the rate of the past two decades (Exhibit E1).

Exhibit E1

Without a boost in productivity growth, Mexico's GDP growth could slow to 2 percent per year

Annual real GDP growth rates

%



1 Workers joining the labor force due to population growth and increased participation rates; employment rate assumed constant at 2012 level.

NOTE: Numbers may not sum due to rounding.

SOURCE: Instituto Nacional de Estadística y Geografía (INEGI); *Encuesta Nacional de Ocupación y Empleo*, INEGI; McKinsey Global Institute analysis

We see abundant opportunities to raise Mexican productivity to rates that would accelerate GDP growth. Mexico has many of the ingredients in place for both productivity improvement and accelerated GDP growth. It has not stinted on investment—roughly a quarter of its GDP goes into fixed capital investment, a rate lower than in rapidly growing Asian economies but among the highest in Latin America. And Mexico's macroeconomic environment has become increasingly stable over the past decades. Mexico has adopted many important market-opening reforms that have enabled the success of highly productive modern companies. As these large private corporations have been exposed to global competition at home and have expanded abroad, they have sharpened their operating skills.

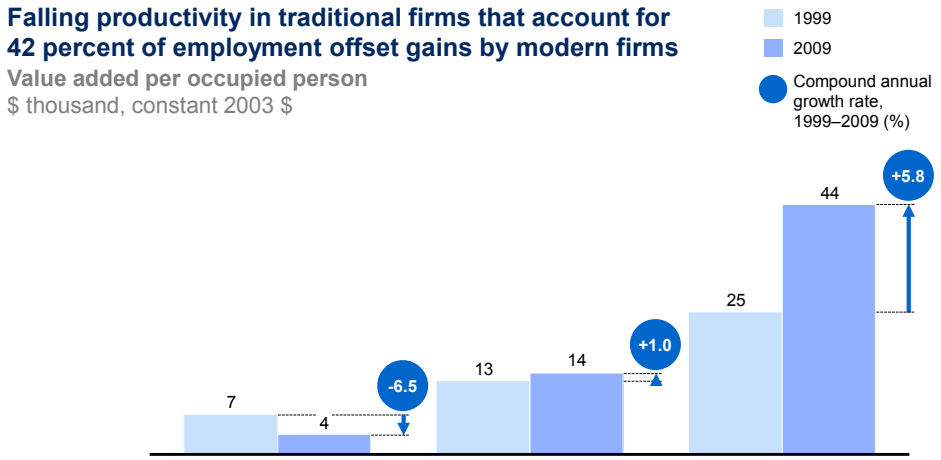
The strength of modern-sector players, however, has not been sufficient to lift Mexico's growth trajectory. Instead, modern-sector growth and productivity are increasingly eclipsed by the weakness of the traditional sector. While large modern corporations raised productivity by 5.8 percent per year from 1999 to 2009 and mid-sized companies raised productivity by 1.0 percent per year, the productivity of traditional enterprises fell by a staggering 6.5 percent a year.[3] And the impact of that is magnified because the number of workers in traditional enterprises is growing: in 1999, 39 percent of all workers were employed in low-productivity traditional enterprises; by 2009, that proportion had risen to 42 percent.

Mexico's mid-sized companies (with 11 to 500 employees) represent another challenge. With some exceptions, mid-sized businesses have not been a source of innovation, job creation, and dynamic change in the economy. Not only has their productivity growth been weak, their share of employment has declined from 41 percent of all employees in 1999 to 38 percent in 2009. In industries where products and services are heavily traded, mid-sized companies—particularly manufacturers, which face rising imports from low-cost locations—have lost ground. Mid-sized companies are also constrained by lack of access to capital, as well as competition from a growing pool of informal competitors that gain a cost advantage by evading taxes and employing workers off the books. With weak contributions to productivity by mid-sized companies, the falling productivity of the vast number of small traditional enterprises has all but canceled out the gains of modern companies in national averages (Exhibit E2).

Exhibit E2

Falling productivity in traditional firms that account for 42 percent of employment offset gains by modern firms

Value added per occupied person
$ thousand, constant 2003 $



Number of employees	≤10	11–500	>500
Share of employment, 2009 %	42	38	20
Share of employment, 1999 %	39	41	20

SOURCE: *Censos Económicos 1999*, *Censos Económicos 2009*, Instituto Nacional de Estadística y Geografía; McKinsey Global Institute analysis

3 Measuring productivity changes over time is notoriously challenging, and particularly so for small, at times informal establishments. However, the overall declining trend is consistent across multiple available sources and estimation methods. All data quoted are based on the 1999 and 2009 *Censos Económicos* (National Economic Census), which encompasses both formal and informal companies, from the Instituto Nacional de Estadística y Geografía (National Institute of Statistics and Geography).

The flagging productivity of traditional businesses has come with a high human cost, as declining productivity has depressed incomes of low-skill workers. Wages in traditional firms with ten or fewer employees, adjusted for inflation, shrank by 2.4 percent per year from 1999 to 2009. From 2008 to 2012, income from independent work (in the informal economy) dropped by an estimated 22 percent.[4] In Mexico's largest companies, wages have remained static, despite rapid advances in productivity. Stagnant and falling wages not only make life more difficult for millions of Mexicans, but they also hold back the expansion of Mexico's consuming class and limit the purchasing power needed for domestic demand to spur sustained growth.

Prescribing many of the measures that are needed to improve productivity in traditional enterprises is straightforward—many strategies, such as introducing labor-saving equipment and improving basic business processes, have not been applied. The more difficult task is to understand why these solutions are not yet in place. To bring about change in the traditional sector, Mexico needs to understand and tackle the reasons business owners are not seeking to make the operational changes and investments required to grow and raise productivity. Mexico also must look carefully for regulations and tax laws that limit modern-sector expansion.

Boost productivity in traditional enterprises and sustain productivity growth in the modern sector

A central focus of this report is to identify actions to boost productivity by private players—both traditional and modern—in major sectors of the Mexican economy. We also examine ways in which policy makers can remove incentives that keep businesses in the traditional sector and inhibit the growth of the modern sector. To identify specific opportunities for realizing productivity gains across the Mexican economy, we use a sector-based approach. We focus on food processing, auto manufacturing, and retail, because of their large size and the catalytic role they can play in the economy. Within these sectors, we isolate opportunities through a two-step approach. We start with a bottom-up assessment of the operational factors that lead to success in the segment and that companies can control, such as adopting technology or developing superior capabilities in certain types of operations. Then we take into account external factors that influence a firm's ability to make such improvements, such as the competitive and regulatory environment.

ADDRESSING PRODUCTIVITY IN THE TRADITIONAL SEGMENT

Food processing, Mexico's largest manufacturing industry, provides a striking example of the stark contrast between the productivity of the largest modern players and of the traditional companies that outnumber them. The 0.5 percent of baking-industry employees who work in the very large, best-in-class corporations generate half of the industry's value added. The vast majority of baking employees, however, work in traditional neighborhood *panaderías* (bakeries) and *tortillerías* (small-scale tortilla factories), which have—at best—one-fiftieth the

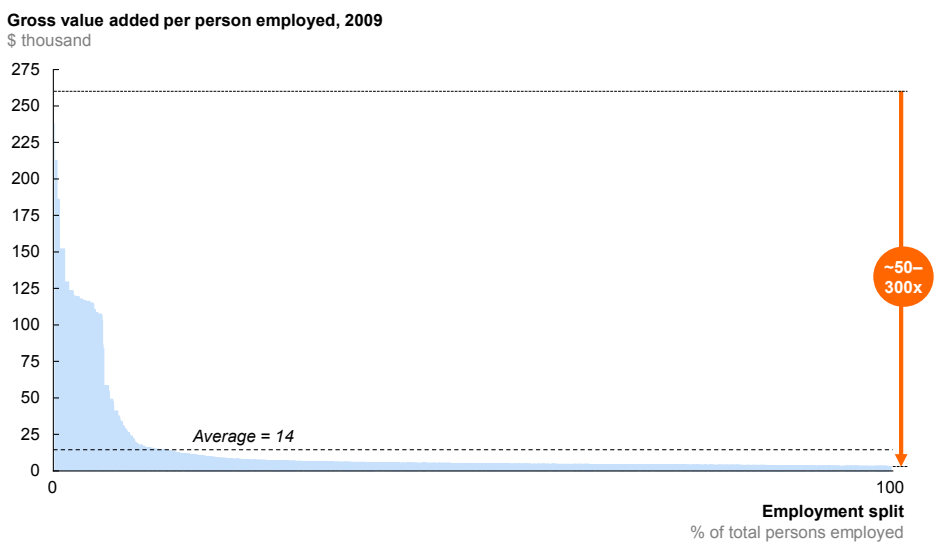
4 *Encuesta Nacional de Ingresos y Gastos de los Hogares*, or ENIGH (National survey of household income and expenditure) 2012, Instituto Nacional de Estadística y Geografía.

productivity of the best-in-class large bakeries and one-twentieth the productivity of the average industrial bakery (Exhibit E3).

Exhibit E3

In the long tail of traditional firms in baking, productivity is 1/50th to 1/300th the level of top performers

Mexico labor productivity vs. share of employment in baked goods[1]



1 NAICS industry code 3118 only.

SOURCE: *Censos Económicos 2009*, Instituto Nacional de Estadística y Geografía (INEGI); INEGI Annual Manufacturing Survey 2011; IMF; World Input-Output Database 2012; McKinsey Global Institute analysis

The "long tail" of unproductive traditional enterprises is also a large force in auto manufacturing. The global parts makers and auto assemblers that have flourished under NAFTA rely on a network of local subcontractors that assemble components such as wiring harnesses using low-cost, low-skill labor. Subcontractors with ten or fewer employees, which account for 80 percent of enterprises and 40 percent of sector employment, have one-tenth the productivity of the modern parts suppliers for which they work.

Manufacturing enterprises can raise productivity in many ways. Some of these, such as investing in productivity-improving equipment and technologies, may be beyond the reach of traditional enterprises that lack scale and access to capital (which we discuss below). However, companies of all sizes can introduce process improvements and strategies such as adjusting product mix to include more high-value-added items. In addition, small enterprises can join buying consortia to qualify for discounts and gain access to better raw materials. In this way, for example, small bakers might raise quality and generate higher profits to invest in productivity-improving equipment.

Food and beverage stores, the largest subsegment of the retail industry, present an enormous opportunity for productivity improvement. Mexican food retailing went through a significant transformation after the sector was opened up to foreign investors in the 1990s, and today modern-format chains account for 65 percent of sales.[5] Yet traditional mom-and-pop stores, market stalls, and counter stores continue to proliferate. They employ 84 percent of workers in food and beverage retailing but have only 20 percent of the productivity of modern

5 For more details on the food retailing transformation, see *New horizons: Multinational company investment in emerging economies*, McKinsey Global Institute, October 2003.

stores. Many small stores have limited display space, requiring workers to take orders or suggest items to customers and fetch merchandise from storerooms, lengthening transaction times and hampering productivity.

Simple operational improvements, such as layouts that allow self-service and buying consortia, could help small-scale retailers. Today, wholesalers sometimes charge small stores more than retail prices available at modern discount stores. The Independent Grocers Alliance (IGA) was started in the United States to help small grocers. It now operates in 30 countries, providing store owners with store-branded products, standardized layouts, and logistics. Food manufacturers, which already support mom-and-pop stores with infrastructure such as beverage cases, can add other services such as access to capital and technology for inventory management and ordering. Finally, small shop owners can consider joining franchise chains to gain scale benefits and operating expertise.

SUSTAINING PRODUCTIVITY IN THE MODERN SECTOR

Mexico has built one of the world's top 15 global manufacturing economies (by gross value added) and has become one of the top five auto producers, with assembly plants of seven global automakers and operations of leading global parts suppliers. Annual production at the ten largest Mexican plants rose from 1.1 million vehicles in 1994, the year NAFTA went into effect, to nearly 2.9 million in 2012. Many Mexican plants are regarded as world-class, and some exceed average US productivity levels. In food processing, Grupo Bimbo is a highly automated global player that has become the largest baking company in the world. In food and beverage retailing, operators of modern-format stores have introduced the latest practices in supply-chain management, marketing, and other operations, which has contributed to the industry's productivity.

For Mexico to achieve its growth aspirations, modern manufacturers and retailers must continue to improve their productivity, while the pool of modern companies and the number of people they employ need to expand. Fortunately, there is room for much more progress in both areas. Modern manufacturers can raise the value of their output by optimizing product mixes, improving quality, and innovating. They also can reduce inputs through efficiency measures, investment in technology and automation, and optimizing supply chains. The Mexican subsidiaries of global assemblers, for example, may be able to source more parts locally rather than importing them from global supply chains. Today, assemblers and global parts makers import many of the components that go into their finished goods, and some 70 percent of the value of their exports from Mexico is based on imported parts. Bringing local suppliers up to global standards may require some training and investment, but the savings and supply-chain simplification can make the effort worthwhile.

In food and beverage retailing, modern-format stores can narrow the productivity gap with US-based stores (they are now about 68 percent as productive as comparable US stores) through further operational improvements. Continuing to raise the share of modern stores in food retailing is a major opportunity for improving sector productivity. We estimate that if the share of modern-format stores can rise from 65 percent now to 75 percent by 2025, sector productivity then could be 25 percent above the 2012 level.

Beyond these improvements by individual operators, Mexico needs to find ways to create a larger, more dynamic modern sector that spans industries and includes companies of all sizes. More small companies need to grow into modern mid-sized companies, and more mid-sized companies need to grow into large modern corporations. The country also needs more entries by new modern companies every year to continue to inject dynamism into the economy and enable creative destruction to take its course so that the modern sector can expand and new industries can rise.

Today, Mexico does not resemble a dynamic economy. Academic research has shown that the entry of new and more productive players and the exit of less productive ones are important contributors to aggregate productivity growth.[6] Mexico, however, has the lowest rate of new company entries among major developed and emerging countries.[7] In addition, Mexican companies may expand less rapidly than those in other countries. Mexican manufacturing plants tend to invest less in process efficiency, quality, and market expansion, and as a result add capacity only half as rapidly as US plants. In the United States, a 40-year-old plant is typically four times as large in terms of employment as a 25-year-old plant in the same industry, but in Mexico, there is no difference in employment between a 40-year-old plant and a 25-year-old plant.[8]

The path of equity markets is another sign of Mexico's lack of economic dynamism. Fewer publicly traded companies exist today than in 2000 due to acquisitions (for example, Grupo Modelo's acquisition by AB-InBev) and a dearth of initial public offerings. IPOs in Mexico raised only $1.9 billion a year from 2000 to 2013, compared with $54 billion per year in the United States.

An important source of dynamic economic activity—fast-growing companies—is also relatively limited in Mexico. In the United States, rapidly growing companies, sometimes called "gazelles," contribute an overwhelming share of all job growth.[9] There are signs that entrepreneurial SMEs can succeed in Mexico, with examples such as Doña Tota, a *gordita* restaurant chain that was recently acquired by FEMSA, owner of Oxxo, a leading convenience store chain, and City Express, a startup middle-market hotel chain that has become number two countrywide and was recently listed on the Mexican Stock Exchange. But Mexico needs many more such companies to affect overall growth.

6 See Lucia Foster, John Haltiwanger, and C. J. Krizan, *The link between aggregate and micro productivity growth: Evidence from retail trade*, NBER working paper number 9120, August 2002.

7 See John C. Haltiwanger, Eric Bartelsman, and Stefano Scarpetta, *Microeconomic evidence of creative destruction in industrial and developing countries*, World Bank, 2004. The authors, however, find that the growth of new Mexican companies in their first seven years is relatively high.

8 Chang-Tai Hsieh and Peter J. Klenow, *The life cycle of plants in India and Mexico*, NBER working paper number 18133, June 2012.

9 Analyses by the Corporate Research Board and American Corporate Statistical Library show that high-growth companies represent just 6 percent of all US companies but contribute almost all net employment growth.

Remove barriers to boost productivity and growth for all sectors of the Mexican economy

A dynamic economy where companies can take full advantage of opportunities to grow and compete more effectively requires the foundation of a strong business environment. In Mexico, significant barriers to growth and productivity remain, despite the reforms of the past three decades.[10] Small companies today, for example, respond to incentives in the regulatory regime that reward business owners for staying small and informal, creating a substantial barrier to growth. At the same time, competitive pressure from the modern sector is held back by restrictive zoning and other preferences for small businesses. And all Mexican businesses would benefit from lower-cost and more reliable energy supplies, improved infrastructure, investment in labor force skills, and a more secure business environment. Collectively, these barriers create friction and reduce rewards for entrepreneurship, slowing the speed of economic change.

The current reform agenda of the Mexican government touches on many issues that we identify as necessary to boost growth: regulatory reforms, improved access to capital, and an enhanced business climate. Many of these reforms have not been translated into specific legislation nor implemented yet, and our assessment of measures that could enable growth relies on observations made before the reform agenda has had substantial impact.

ADDRESS REGULATORY HURDLES AND REMOVE DISINCENTIVES FOR GROWTH

Many companies remain small and continue to operate informally because they have economic incentives to do so. The regulatory cost of establishing and operating a formal enterprise in Mexico is relatively high, and enforcement is weak and too often tainted by corruption, enticing companies of all sizes to conduct all or part of their business beyond the strictures of the formal economy. Small companies enjoy a variety of preferences. For example, companies under a certain size can purchase electricity at the consumer rate and may qualify for subsidies that can cover 80 percent of their costs. Small companies also enjoy tax exemptions, while zoning insulates them from modern competitors that would force them to become more productive. Efforts in the following areas could remove incentives to stay small and unproductive and could provide a more level playing field for all companies:

- **Reduce regulatory complexity.** Not only is it far costlier to start a formal business in Mexico than in peer countries, but it also costs more to expand: construction permits cost three times the average income per capita vs. 67 percent in Chile. There are also wide variations in regulatory processes and regulations within Mexico (a complication also seen in other countries): it takes six days to start a business in Monterrey and 49 days in Cancún, and the simplest regulations—such as the height at which to hang a fire extinguisher—vary from state to state.

10 For a comprehensive synthesis of the literature assessing reasons behind Mexico's performance, see Gordon H. Hanson, "Why isn't Mexico rich?" *Journal of Economic Literature*, volume 48, number 4, December 2010.

- **Improve enforcement.** An estimated 54 percent of Mexico's non-agricultural workers are employed in the informal sector, and informality is rising. Informal companies avoid paying into the social security system, complying with sanitary and environmental regulations, and filing paperwork. As a result, informal establishments enjoy cost advantages over more compliant and formal firms. Raising the odds of prosecution for tax fraud or other violations would not only discourage informality but it would also help compliant companies survive and prosper.

- **Remove incentives to remain small and unproductive.** Traditional markets and *tianguis* (street markets) pay only license fees, while modern formal stores pay sales tax as well as employment taxes. Employees of informal enterprises have little incentive to push employers to make payments for social insurance programs since they can get nearly identical benefits through programs for the poor.[11] Unproductive enterprises of all sizes are protected by remaining trade barriers, including high tariffs for even most-favored nations such as China, antidumping rules, and excessively costly customs procedures.

- **Further improve labor flexibility.** Mexico has liberalized some labor rules, but it still has relatively restrictive labor laws.[12] This constrains hiring by large companies and makes it difficult for small employers to operate formally. By staying informal, firms keep the option of letting employees go and can pay workers less than the minimum wage.

- **Ensure that zoning does not reduce competition.** Many communities have enacted zoning rules that limit construction of modern-format stores to protect traditional stores and the jobs they provide. But by limiting the growth of modern-format stores and the competition they would introduce, these regulations are a barrier to higher productivity.

IMPROVE ACCESS TO CAPITAL

For small and mid-sized businesses, lack of capital frustrates expansion plans and forces companies to rely excessively on labor-intensive methods to raise output (often using family or informal workers), rather than making capital investments. This exacerbates the productivity problem. Bank loans are a traditional source of financing for SMEs, but lending activity is very limited in Mexico. Lending in advanced economies, as a share of GDP, is 4.5 times the level in Mexico. The country has fewer loans outstanding than Brazil and other Latin American peers. At 33 percent of GDP, Mexico's lending places it behind Ethiopia, a nation with much lower GDP per capita.

The World Bank estimates that 53 percent of Mexico's medium-sized firms are underserved by the domestic financial industry. Furthermore, the mid-sized firms that do have access to credit pay a very high cost compared with what large corporate bond issuers and SMEs pay in the United States (Exhibit E4). By contrast, foreign multinationals operating in Mexico and Mexico's largest modern

11 Matías Busso, María Victoria Fazio, and Santiago Levy, *(In)formal and (un)productive: The productivity costs of excessive informality in Mexico*, Inter-American Development Bank working paper number IDB-WP-341, August 2012.

12 According to the OECD, Mexico's 2012 labor reforms might move the country up to fourth place from 11th in rankings for restrictive labor practices. *OECD economic surveys: Mexico 2013*, OECD Publishing, May 2013.

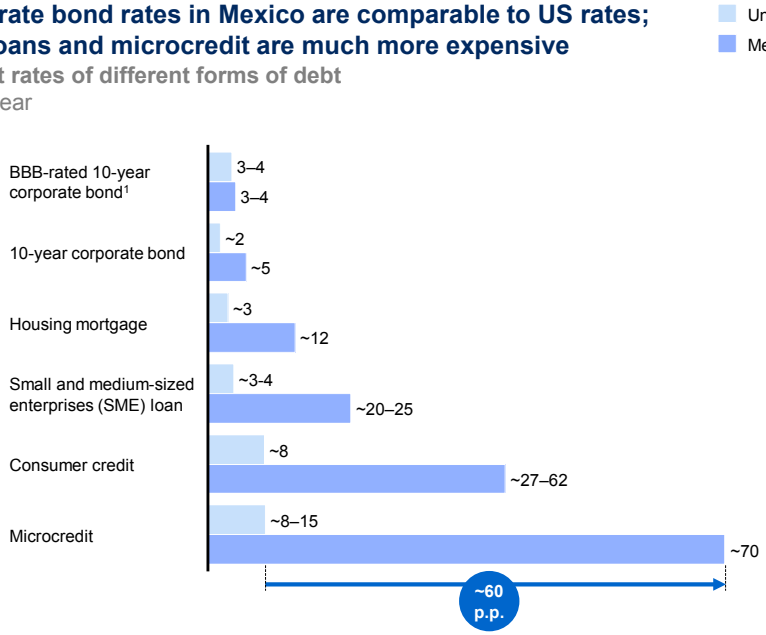
corporations have access to capital markets around the world and benefit from a relatively low cost of capital.

Exhibit E4

Corporate bond rates in Mexico are comparable to US rates; SME loans and microcredit are much more expensive

Interest rates of different forms of debt

% per year



1 PPL Energy Supply, LLC in the United States and Banco Santander de México in Mexico.

SOURCE: Bloomberg; Banco de Mexico; McKinsey Global Institute analysis

The unmet capital needs of firms with ten to 250 employees represent 75 percent of what we estimate to be a $60 billion credit gap in Mexico. The credit gap limits entry by new businesses and prevents mid-sized companies from growing into major employers and making larger contributions to GDP. It also removes the capital cushion that can keep companies viable in the face of market shocks. Furthermore, it holds back productivity gains: the mid-sized companies that are being deprived of credit are precisely the companies that need to invest in machinery and technology to drive modern-sector productivity gains.

Mexico can take several steps to improve access to credit across the nation. Regulatory changes, such as improving protections for creditors in bankruptcies, would encourage lending, and the government has made some progress in insolvency regulation. Improvements in Mexico's financial infrastructure would also help. And better auditing systems and credit reporting resources would make risks more explicit and enable more lending.

IMPROVE ENERGY SUPPLY, INFRASTRUCTURE, SKILLS, AND SECURITY

Beyond reforms to regulations, Mexico can strengthen its overall business environment to increase its global competitiveness and support the growth of domestic industries. High costs of electricity, gaps in infrastructure and skills, and rising security concerns are all barriers to growth.

- **Increase energy productivity.** Electricity for commercial customers in Mexico costs 73 percent more than it does for commercial users in the United States. The World Economic Forum ranks Mexico 79 out of 144 countries for the cost and quality of its industrial electricity supply. We estimate that Mexico could

reduce total energy costs by as much as 20 percent by addressing issues of supply and demand, including raising the proportion of electricity generated with natural gas and further developing low-cost renewables. On the demand side, Mexico can raise fuel-economy standards and expand public transportation, perhaps by adding more bus rapid transit.

- **Close the infrastructure gap.** Mexico's infrastructure is not adequate to support future growth. To bring infrastructure stock up to the global average of infrastructure stock to GDP, we estimate that the nation would need to spend $71 billion per year through 2025 to support expected growth. Filling these gaps will enable Mexico to support growth and provide for the needs of an expanding economy—and perhaps address issues of economic inclusion at the same time. Using measures to improve the productivity of infrastructure investments, Mexico could reduce the cost of building the necessary infrastructure by as much as 40 percent.[13]

- **Build workforce skills.** Mexico lags behind other countries, including large Latin American peers, in both the level and quality of education. Today, the average Mexican has only nine years of formal schooling and few opportunities to get on-the-job training in globally competitive businesses. Addressing the shortcomings of the educational system will take many years. However, in the short term, Mexico can focus on upgrading vocational education, aligning curricula with employer needs, developing more employer-sponsored training programs, creating rapid training courses, and improving labor-market matching mechanisms.

- **Improve safety.** Security is a concern for most businesses operating in Mexico. Mexico rates poorly on the World Economic Forum's country rankings for costs of crime and violence, presence of organized crime, and reliability of police services. On organized crime, it ranks 139 out of 144 countries. The challenge for Mexico is to build capabilities in the police force and judiciary to be able to combat violence and crime and reduce related corruption.[14]

Implications for Mexico's economy

If Mexico succeeds in boosting the productivity of traditional companies, sustains productivity growth in the modern sector, and addresses barriers to growth across the economy, a 3.5 percent growth target is feasible. While this is an aggressive goal, it can be reached if both the public and the private sectors are determined to make the change happen. The nation will face some dislocations in existing businesses—and can consider appropriate measures to ease the transition for workers—as the process of creative destruction plays out.

We do not underestimate the extent of the changes that will be needed. To unleash growth and productivity, longstanding political, judicial, and regulatory practices will need to be modified, and this cannot happen overnight. Yet our analyses strongly suggest that there is no alternative: Mexico not only needs strategies to address structural issues, it also needs to shift ingrained institutional

13 Such savings have been achieved in other economies using strategies described in *Infrastructure productivity: How to save $1 trillion a year*, McKinsey Global Institute, January 2013.

14 *The global competitiveness report 2012–2013: Full data edition*, World Economic Forum, 2012.

practices. Mexico needs to enforce a rule of law that allows lenders to trust that they can collect on their loans and ensures that businesses have a fair opportunity to reap the benefits of their investments. Most important of all, Mexico needs to become a place where those who do not play by the rules will be penalized and where formal, compliant companies are free to go as far as the energies and talent of their workers can take them.

Changing Mexican business practices may take many years, perhaps a generation. In the near term, the Mexican people, business owners, investors, and policy makers have much to do. The private sector has a key role to play in identifying opportunities for improvement—within organizations and industries and beyond. Mexico will need investments of financial and human capital to act on those opportunities. We identify actions on three fronts, described below, that will be needed by policy makers and private-sector leaders:

- **Help traditional enterprises evolve into modern, formal SMEs.** With appropriate government actions to make informality less attractive, assistance from the private sector, and efforts by small business owners, many of Mexico's traditional enterprises can evolve into modern companies. First, government should examine incentives, such as tax preferences, that make it economically attractive for companies to remain small and informal. At the same time, government can make it far easier to register a business or obtain a permit; investments in online and self-service systems will be money well spent.

  The most powerful prod, however, will be rigorous enforcement.[15] It should become abundantly clear to business owners that if they are not paying taxes or meeting other obligations, they are likely to be caught, and that when they are caught they will be prosecuted. To do this, government will have to invest in new systems and capabilities. Moving toward digital payments for government transactions can help. In Brazil, businesses that submit digital receipts of business expenses are eligible for special tax breaks. Using big-data analytics, tax authorities can use such files to uncover possible fraud (if the company that issued the receipt for the reported expenses did not also report the income, for example). To make sure laws are enforced equitably, government must root out corruption in agencies and in the field.

  The private sector can help bring small enterprises into the formal economy, too. Large manufacturers can integrate more closely with the small companies in their supply chains, perhaps helping them finance the online systems to tie them into production systems and help subcontractors manage inventory and scheduling. Large manufacturers can also work with local governments to find ways to bring smaller firms into industry clusters. Finally, business owners will need to decide to move up to the formal sector—because the path is clearer and the benefits of staying informal are diminishing.

- **Expand access to capital, particularly for mid-sized companies.** The inability to access credit and the high cost of credit are major obstacles for

15 Research by the World Bank in Brazil found that of all government measures aimed at reducing informality, only enforcement influenced formalization rates. Gustavo Henrique de Andrade, Miriam Bruhn, and David McKenzie, *A helping hand or the long arm of the law? Experimental evidence on what governments can do to formalize firms*, World Bank policy research working paper 6435, May 2013.

the growth of the mid-sized businesses that can create new jobs, innovate, and aspire to become Mexico's next leading companies. Government and the private sector—banks as well as large corporations—can help. Financial reforms should include strengthening support for creditors to encourage lending, such as by improving the process for recovering collateral. The World Bank, for example, recommends a national system for registering movable assets such as business equipment. Government can push for improvements in credit reporting, too.

Banks can help by going back to "growing" their business customers—starting with small loans and staying with the same clients as they prosper and need additional services. Banks can also modernize their credit-granting processes, using data analytics and new unconventional forms of information that can be used to gauge creditworthiness. Many aspiring business owners do not fit the profile that conventional credit reviews require, but they may be excellent risks.

Mexico's leading businesses can also do their part to help SMEs finance growth. One easy step would be to make prompt payments to small suppliers—waiting 90 or 120 days for payments can wreak havoc on a small business. Large companies with access to low-cost capital can also help finance smaller partners directly, by offering financing for equipment or technology purchases, for example. There is room for innovative solutions to boost lending and close the credit gap. In China, Alibaba, the operator of massive online markets, has become one of the nation's largest SME lenders and is in the process of obtaining a banking license.

- **Continue to make Mexico a place where world-class companies prosper.** Through decades of policy reforms and trade agreements such as NAFTA, Mexico has become an attractive place for world-class companies to locate operations, as well as a place where world-class companies are born. To allow such companies to maintain their momentum, government can further enhance the business environment by upgrading infrastructure, improving the cost and reliability of energy, and educating workers for higher-skill employment. Addressing security issues, an area of ongoing concern, will also be important.

  The private sector will continue to have a key role to play. The investment climate remains favorable despite crime concerns; Mexico's global firms and multinationals continue to see Mexico as a core production location for the North American market and can be expected to expand their operations to create more jobs. Local and global private equity investors can help enable the change that Mexico needs by identifying opportunities for productivity improvements in companies and better performance in specific industries.

  Formalizing and revitalizing the traditional sector and enabling the growth of mid-sized companies are essential steps to restore growth. Mexico must reverse the productivity decline in its smallest enterprises and start moving workers from low-productivity work to higher-productivity jobs in the modern sector. Government, the private sector, and Mexican citizens will all need to pull in the same direction for the two Mexicos to move ahead.

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